

*The Impact of Demographic Trends on the Budget and
Long-Term Fiscal Policy*

Testimony of

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Introduction

Chairman Domenici, Senator Conrad, and Members of the Committee, I am pleased to be here to discuss some of the federal budget implications of the anticipated demographic changes over the next 40 years. You face a considerable challenge in grappling with the budget for next year, knowing that decisions made today will affect future budgets. You are clearly concerned about the budgetary implications of the retirement of the baby-boom. And although the full budget implications of this transition are more than 20 years away, it is not too soon to begin to respond to this challenge. The long-range budget projections provide both a warning and an opportunity to broaden the policy discussion to consider options that go beyond just altering the entitlement programs.

Medicare, Medicaid, and Social Security expenditures are currently about 7.5 percent of gross domestic product (GDP).¹ The Congressional Budget Office (CBO) projects that by 2040, outlays in these three programs will increase substantially. In fact, they estimate that these expenditures will grow faster than the economy. CBO projections of Medicare, Social Security, and Medicaid spending, along with their projections of economic growth, suggest that expenditures for these three programs combined could be between 14.3 to 19.6 percent of GDP.[FN] This range reflects variation in assumptions concerning health care costs, productivity, and population growth.

Between now and 2040, the population eligible for Social Security and Medicare is expected to more than double, increasing 117 percent, and hence it makes sense that spending on these programs, as a proportion of our nation's income, is also likely to more than double. Most reasonable assumptions of economic growth suggest that to meet the expenditures of Social Security and Medicare, additional tax revenues will be needed, or alternatively, program benefits will need to be cut.

The Trustees of the Social Security Trust Funds have noted that the Old Age Survivors and Disability Insurance Trust Fund will be depleted by 2037 and the Hospital Insurance Trust Fund will be depleted by 2025, using their intermediate, or "best-guess" assumptions. Under their high-cost assumptions, in which the economy grows slower, people live longer, or health care expenditures are greater, the Trust Funds will be depleted substantially sooner. Under the Trustee's low-cost assumptions, the economy grows a bit

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¹ Congressional Budget Office, The Long-Term Budget Outlook, October 2000.

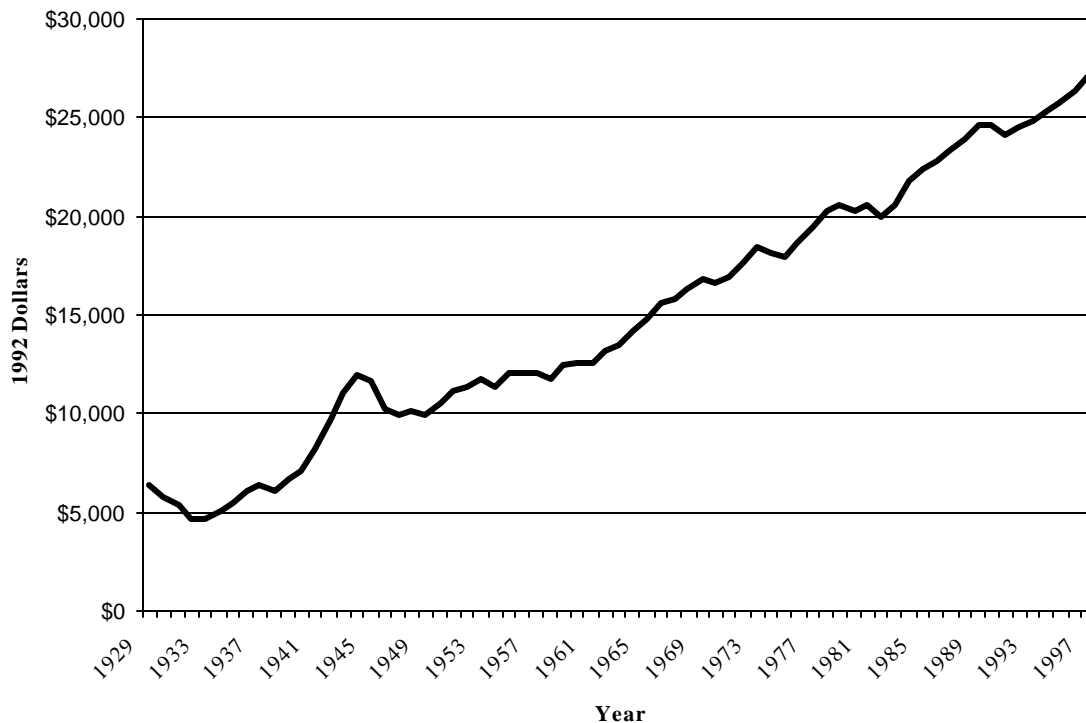
faster, life expectancy does not increase as much, or health care expenditures do not increase as much as assumed under their intermediate assumptions, then the Trust Funds remain solvent through the 75-year projection period.

Looking Back to Consider the Future

Society is aging because of two distinct phenomena. One is the vast improvement in life expectancy. This is worth celebrating. For most of recorded history, relatively few people lived beyond age 45. In stark contrast, life expectancy at birth today is at least 70 years of age in the United States and even higher in Japan.² We now expect most people to reach age 65 and of those who do, life expectancy at age 65 is another 16 years for men and 19 years for women.

The other reason society is aging is because women have been having fewer children over the course of their lifetime. Declining fertility rates, even more than the increases in life expectancy, have resulted in a growing proportion of our society that is older. These two distinct trends have implications for family life, the economy, and society. The increased likelihood of living longer, in combination with lower fertility rates,

Figure 1. Real GDP Per Capita



Source: Bureau of Economic Analysis, *National Income Product Accounts*, October 1998.

²Robert B. Friedland, "Life Expectancy in the Future: A Summary of a Discussion Among Experts," in *North American Actuarial Journal*, October 1998.

suggest that parents have fewer children to nurture, and those children are more likely to know their grandparents.

Society has been aging for a very long time but it has not seemed to diminish economic capacity.³ Despite the doubling of the population age 65 and older since 1962 or the quadrupling of this population since 1938, standards of living have increased. Real GDP per person has increased 120 percent since 1962. Since 1938, real GDP per person has more than quadrupled, increasing on average 5.9 percent a year. Figure 1 shows real GDP per capita since 1929.

There are currently about 35 million people ages 65 or older. The projections for 2040 indicate that there could be 77 million people age 65 or older.⁴ Over this same time period, the overall population is projected to increase from about 272 to 377 million people, suggesting that the proportion of the population that is age 65 or older will increase from 13 percent to 20 percent by 2040.⁵ From the perspective of consumers and taxpayers, the population age 18 and older, between now and 2040 is expected to increase 38 percent.

Longer life imposes a personal and collective challenge: being able to finance these additional years and insure against the additional financial risks such as needing long-term care. While more people will survive into old age, more people will also face the risk of outliving their assets. This is not only because many assets are not indexed for increases in the cost of living, but also because more people are surviving acute health care situations only to find that they have a chronic health condition or that they need long-term care to function on a daily basis. Medicare does not cover all of the expenses associated with chronic care; nor does it cover most of the expenses related to long-term care needs.

Medicare and Social Security

Medicare was enacted in 1965, implemented in 1966, and fully underway by 1967. Between 1967 and 1999, the population of the United States increased 37.5 percent while the population age 65 and older increased 81.3 percent. Medicare and Social Security expenditures increased a frightening 23-fold in nominal terms, while the federal budget increased by more than 10-fold. As a percent of GDP, Social Security and Medicare expenditures nearly doubled from 3.6 percent to 6.4 percent. However, despite the increase in beneficiaries and the increase in entitlement expenditures, the federal budget as a percent of GDP did not increase. In fact, it declined from 22.9 percent to 18.3 percent of GDP.

That is, over the past 32 years, Social Security and Medicare beneficiaries almost doubled (increasing 81 percent) and the expenditures as a proportion of national income

³ About 12.7 percent of the population today is age 65 or older compared to just 4 percent in 1900.

⁴ The Census Bureau estimates suggest the possibility of 58.5 to 92 million people age 65 or older in 2040, depending on which series of mortality and immigration rate assumptions are used.

⁵ The Census Bureau estimates suggest the possibility of 288 to 458 million people in 2040, depending on the series of mortality, immigration, and fertility rates assumed.

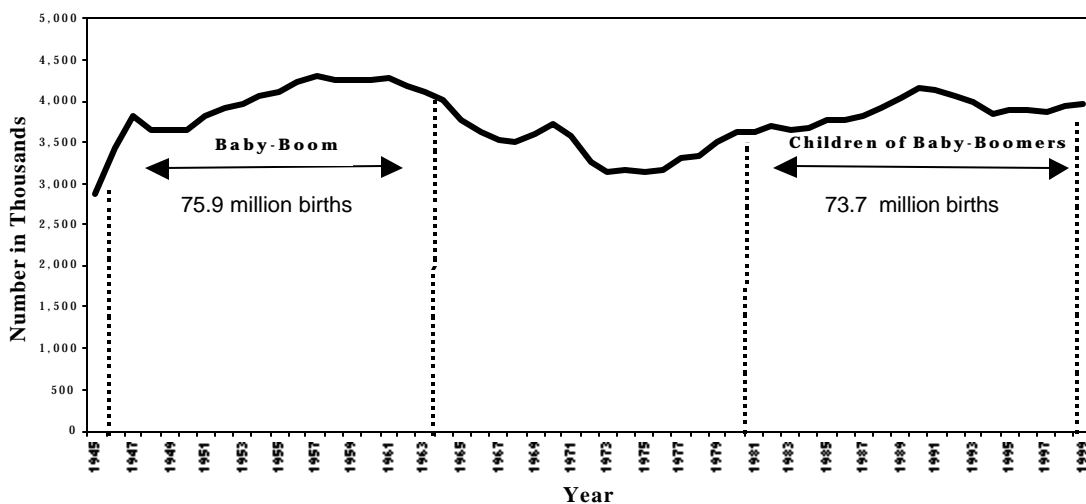
that went to support these two programs increased by a similar amount (78 percent). At the same time, the federal budget, as a percent of GDP, declined. Medicare and Social Security now constitute a larger share of the federal budget (increasing from 15.6 percent to 34.7 percent) while discretionary spending including defense spending have become smaller shares. Gross domestic product, however, increased in real terms an average of 3.2 percent per year.⁶

It is worth dwelling on this point. Over the past 30 years the Medicare Hospital Insurance Trust fund was projected to be insolvent within a couple of years at least nine different times. Social Security was within several months of insolvency at least twice. Difficult choices, often at the very last minute, were made. The challenge of the demographic changes arising from population aging was met. In fact, the changes in Social Security that were enacted in 1983 have contributed to the budget surpluses that are now central to your deliberations.

The Baby-Boom

Fertility rates have been declining for a very long time. The baby-boom, however, reflects a substantial period of time in which fertility rates increased and remained above the historical trend. Following World War II a generation of Americans born during the Depression began to anticipate a standard of living that far exceeded their expectations. This resulted in a dramatic increase in fertility rates from 1946 until about the mid-1950s. By 1964, fertility rates were back to where they had been prior to 1946, resulting in an 18-

Figure 2. Number of Live Births



Source: U.S. Census Bureau, *Historical Statistics of the United States: Colonial Times to 1970*, Series B1-4.
National Center for Health Statistics, *National Vital Statistics Reports*, Vol. 48, No. 3.

⁶ In 1996 dollars, GDP in 1967 was \$3,280 billion and \$9,027 billion in 1999.

year period in which over 76 million babies were born.

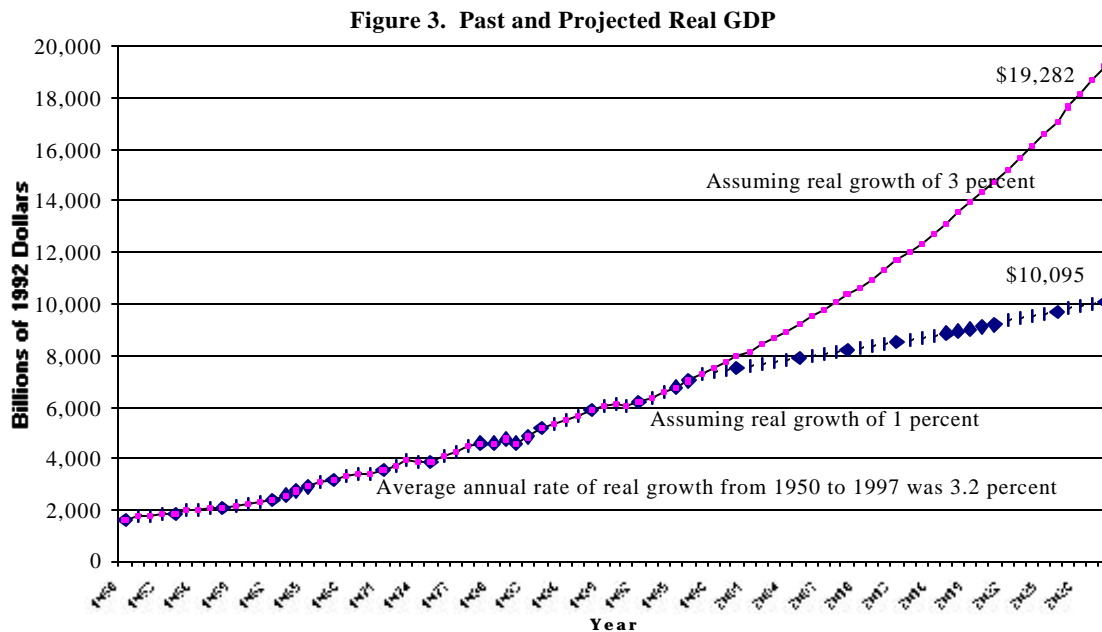
If fertility rates had not increased but rather remained at 1945 levels, there may have been 64 million babies born instead of 76 million. Perhaps the baby-boom is not the nearly 76 million people everyone seems to refer to, but really just the additional 12 million babies.

Nevertheless, those 12 million babies, along with their 64 million brothers, sisters and cousins, grew-up and had families of their own. Baby-boomers had fewer children than their parents, but there were more baby-boomer parents than parents of baby-boomers. As a consequence, over the past 18 years, nearly 74 million babies were born, bring forth a new era of crowded classrooms (see Figure 2). Soon, these children will be entering the labor force.

The Importance of Economic Growth

As evident by the projections for the future and as suggested by looking at the past, federal expenditures for Medicare, Medicaid, and Social Security are likely to increase. But the significance of these increases depends on economic growth. Currently, about one-third of our nation's income is expended through federal, state, and local government budgets. Using independent estimates of government spending in 2030, we have calculated that we could maintain this relative level of total government spending as a percent of GDP, if real economic growth were to average about 3 percent per year between now and 2030.

Although real economic growth exceeded 3 percent over most of the past three decades, the slowdown in productivity in the 1970s raises real doubts about being able to sustain this level of growth. Most experts, including the CBO, project or assume real



Source: Bureau of Economic Analysis...National Income Product Accounts, October 1998.

economic growth of somewhere between 1.6 and 2 percent. Very recent estimates of future economic growth have started to reflect the remarkable increase in productivity in the 1990s. However, even if productivity continues to rise dramatically, and the economy grows substantially faster than most experts assume, there still will be difficult decisions to make concerning the financing of entitlement programs. Figure 3 contrasts economic growth of 3 percent with growth of just 1 percent.

Possible Public Policy Responses

It is not possible to know the future and hence long-range budget projections should be viewed as “early warning signs.” Many different public policy decisions will alter the future and, consequently, the projections for the future. Focusing on the public policies that further economic growth broadens the range of policy options. The longer the time frame, the more options there are. By waiting for a fiscal crisis, the options narrow and increasingly, they narrow to either a large tax increase or a substantial cut in benefits.

Baby-boomers are now 37 to 55 years of age. More than one-half of them are under age 44. We do not know what decisions they will make concerning work and savings over the next two decades. We know that public policies, however, can influence these decisions. By remaining in the labor force longer, for example, federal revenues may be greater and federal expenditures may be lower than currently projected.

Policy efforts should continue to focus on slowing the rate of growth in health care expenditures. In addition, there should be concerted efforts to encourage people to work longer as well as efforts to encourage people to save more. These efforts, however, are likely to only be effective at the margin. Much of the rise in health care expenditures are due to changes in the technologies applied to either the diagnosis or treatment of a condition. People in poor health, especially in physically demanding jobs, may not be able to work. Capital markets are now so large and efficient, that on the margin, more individual savings, while helpful to that individual, will do little to lower the cost of capital and encourage investments. In the longer run, while all of these efforts will contribute, those efforts directed at increasing productivity directly will have the greatest impact on changing the economic and budgetary outlook of the future. The building blocks for real increases in individual and societal prosperity are public and private investments in human capital, the support of basic and applied research, and the maintenance and development of the infrastructure that supports communication and transportation.

Investing in Human Capital

People are our greatest resource. The slowing of the rate of growth in the labor force means that this resource will become scarce relative to the growing demand for goods and services.⁷ It is therefore even more important that each and everyone in the work force

⁷ The entrance of the baby-boom into the labor force coincided with increases in the labor-force participation rate of women of all ages. Consequently, while the labor force is still increasing, it is not increasing, nor is it expected to increase in the future, as quickly as it did for the nearly 20 years in which the baby-boom first entered the labor force. See Robert B. Friedland, *Will Baby Boomers Work More*

not only have the opportunity to acquire skills but also to apply those skills in ways that enable society to take full advantage of everyone's potential. Acquiring the skills to learn and embracing continuous education and training begins early in life and must be sustained over most of one's work life.

Population aging, in combination with the natural forces of the competitive market, is a strong force to encourage people to seek education and acquire new skills. It is also a strong force for encouraging employers to support training and education. However, developing the skills to learn, as well as the desire to learn, stem from the environment prior to kindergarten. The public policy challenge is to take advantage of the competitive forces but also to recognize that the market cannot do it all. The market alone will not ensure that all children have the opportunity to learn how to learn. Nor will the market ensure that everyone has the opportunity for education and training, not only during the formative years, but also over their working years.

Just as critical a challenge, however, is the recognition that not everyone will have the necessary skills or the same opportunities. In addition, not all work requires these skills. Increasingly, those with greater skills are able to not only earn more per hour, but also to work more years while others are in physically demanding jobs with low pay.

In addition, public policies may be necessary to alter some of the conditions that discourage older workers from remaining in the labor force. Defined benefit pension plans encourage people with substantial years of service to leave their employer. By design, at some point, the additional pension benefit associated with an additional year of employment begins to decline. In addition, employers may face legal barriers in restructuring positions in which older workers are able to remain with the firm while collecting some of their pension benefits.

The incentives to become a pensioner and the limits in alternative work arrangements often encourage people to think about changing employers. The skills of that worker, however, may be more valued by their current employer than by other potential employers. Strong preferences for younger workers only compounds the situation and eventually older workers may get discouraged and leave the labor force all together. On the other hand, not everyone will be physically capable of working longer. Poor health, either of the worker or of their spouse, is a primary reason people leave the labor force. Age discrimination, however, often prevents them from returning.

Investing in Research and Infrastructure

Productivity stems from the application of new insights in the hands of entrepreneurs with a vision and workers with the skills. But the root of these advances is derived from basic and applied research. Public financing of research is critical to this process. So too is the public financing of the infrastructures upon which communication and transportation are so vital.

The Population age 65 and Older in the Future

Social Security, Medicare, Medicaid, and the Older Americans Act have each helped people to live independently in old age. These programs provide a base of support and insure a tremendous share of the risks associated with longevity. Poverty rates among the population age 65 and older have declined dramatically. Less than 10 percent of this population has incomes that are below the poverty level. Although these programs have been remarkably successful at enabling older people to remain financially independent, most older people still face considerable risks associated with longevity.

About 40 percent of people ages 65 and older have incomes that are within twice the poverty threshold.⁸ With relatively few financial assets and such tremendous gaps in coverage for chronic and disabling conditions, at least one-half of older people are at risk for outliving their assets or encountering an event that impoverishes them. The longer an individual lives, the greater this risk. The risk is much greater for women, not only because they are more likely to live longer than men, but also because they are more likely to have to finance the uninsured medical and long-term care expenses incurred by their now deceased husband. Social Security benefits vary, but average \$10,029 a year per person - an income level just above poverty. Overall, for more than one-half (58 percent) of people age 65 or older, one-half of their income or more is from Social Security.⁹ Among people age 75 or older, 67 percent derive 50 percent or more of their income from Social Security. For 33 percent of this age group, 90 percent or more of their income is from Social Security.

Despite Medicare coverage, people age 65 and older, overall, spend 22 percent of their income on health insurance, prescription drugs, and Medicare covered benefits.¹⁰ Despite Medicaid and the various Medicare Savings Programs, Medicare beneficiaries with incomes at or below the poverty level spend, on average, 32 percent of their income on health insurance, prescription drugs, and Medicare covered services.¹¹ These estimates of health care spending do not include expenses for long-term care.

We can certainly anticipate that older people of the future will be different from the older population of today. However, it is not altogether clear what changes will occur that will dramatically change the financial circumstances of those who will be older in 2040. Economic growth, working longer and saving more will, in all likelihood, improve the financial status of people turning age 65. But, the additional wealth accumulated is likely

⁸ For single people age 65 or older, the poverty threshold in 2000 is \$8,259 and for married couples it is \$10,409.

⁹ Social Security Administration, *Income of the Population 55 or Older, 1998* (March 2000)

¹⁰ Stephanie Maxwell, Marilyn Moon, and Misha Sigal, *Growth in Medicare and Out-Of-Pocket Spending: Impact on Vulnerable Beneficiaries, January 2001*, The Commonwealth Fund.

¹¹ *Medicare and Low Income Beneficiaries, The Faces of Medicare*. The Henry J. Kaiser Family Foundation, June 1999. The "Medicare Savings Programs" - the Qualified Medicare Beneficiary (QMB), Specified Low-income Medicare Beneficiary (SLMB), and Qualifying Individuals (QI) programs - provide various premium and Medicare cost-sharing protections to Medicare beneficiaries with low incomes and few financial resources. Medicare Savings Programs are administered by State Medicaid programs.

to need to finance an even longer life expectancy. In all likelihood, poor health and disability will still be significant reasons why people leave the labor force in their fifties. Even if life expectancies among older people continue to increase, not everyone will be in good health. Moreover, given the decline in fertility rates, older people in 2040 will have fewer children upon which to depend for physical, emotional, or financial assistance. This is likely to raise the cost of long-term care.

Conclusion

Projecting the size of the federal budget relative to the size of the economy requires making assumptions about future labor force behavior, individual and government savings behavior, interest rates, inflation rates, unemployment rates, and technological advances, as well as the size and age distribution of the population. None of this is knowable. Since more than one-half of this future population has already been born, we have the most confidence in demographic projections. Perhaps because of this confidence, demographic change tends to take on more significance in budget discussions than is appropriate. As we have learned from looking to the past, while population aging matters, other factors also matter. There is no doubt that the federal expenditures for Medicare and Social Security will increase, but the significance of these expenditures, both as a portion of the budget as well as the relative size of the federal budget within the economy, depends on economic growth.

The decline in fertility rates has already initiated a slowing in the rate of growth of new entrants to the labor force. But the growing population ensures a growing demand for goods and services. Upward pressure on wages will, in turn, encourage employers to be more willing to make investments in labor saving technologies as well as investments in the retention and training of older workers.

Public policies that encourage and support lifelong learning, encourage research in basic and applied sciences, and eliminate arbitrary barriers in the flow of human and financial capital, may yield new technologies that open up new markets, and improve efficiency and productivity. Public policies that provide the physical, financial, and educational infrastructure to support and encourage economic growth will increase standards of living and make any of the difficult tax or benefit cut choices less difficult.

Congress has met the budgetary challenge of an aging society in the past. There is little reason to suspect that we will not have the financial resources to meet it in the future. It would be a shame, however, if we wait until the very last moment to act. By waiting, we are left with fewer options, mostly focused on entitlement programs themselves. By broadening the focus to the economy and by taking the long-range projections as an early warning, we can rationally meet the challenge decades before it becomes a crisis.